



Faculty of Economics and Business

**THE IMPACT OF FOREIGN AID ON ECONOMIC GROWTH IN
THE INDOCHINA COUNTRIES**

Yin Pui Mun

**Bachelor of Economics with Honours
(International Economics)
2012**



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INDOCHINA COUNTRIES**

YIN PUI MUN

This project is submitted in partial fulfillment of
the requirements for the degree of Bachelor of Economics with Honours
(International Economics)

Faculty of Economics and Business
UNIVERSITI MALAYSIA SARAWAK
2012

**IMPAK BANTUAN LUAR NEGERI PADA PERTUMBUHAN EKONOMI DI
NEGARA-NEGARA INDOCINA**

YIN PUI MUN

Projek ini merupakan salah satu keperluan untuk
Ijazah Sarjana Muda Ekonomi dengan Kepujian
(Ekonomi Antarabangsa)

Fakulti Ekonomi dan Perniagaan
UNIVERSITI MALAYSIA SARAWAK
2012

Statement of Originality

The work described in this Final Year Project, entitled
**“The Impact of Foreign Aid on Economic Growth in the Indochina
Countries”**

is to the best of the author’s knowledge that of the author except
where due reference is made.

18 June 2012
(Date submitted)

Cassidy
Yin Pui Mun
25424

ABSTRACT

THE IMPACTS OF FOREIGN AID ON ECONOMIC GROWTH IN THE INDOCHINA COUNTRIES

By

Yin Pui Mun

Although foreign assistance has been funded to the developing countries for several decades, many of the recipient countries such as the Indochina countries are still remain underdeveloped and experiencing low growth. This study is conducted to investigate the relationship between foreign aid and economic growth in the Indochina countries namely Cambodia, Lao PDR, Myanmar, Thailand and Vietnam for the period 1993 to 2009. The study incorporates a set of variables including economic growth, official development assistance, and other support variables such as foreign investment and trade openness. The ARDL approach is applied to examine the cointegration relationship among the variables and short-run causality test is performed to analyze the causality effect among the variables. The study found a negative long-run relationship between foreign aid and economic growth in Cambodia, Thailand and Vietnam, while foreign aid of Lao PDR and Myanmar is not significant in generating growth in the long-run. However, the impact of foreign aid on economic growth in the short-run is less significant for all Indochina countries. At the end, it is suggested that these countries should rely upon the internal resources to promote economic growth rather depending on external factors.

ABSTRAK

IMPAK BANTUAN LUAR NEGERI PADA PERTUMBUHAN EKONOMI DI NEGARA-NEGARA INDOCINA

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Walaupun bantuan luar negeri telah dibiayai untuk nagara-nagara membangun sejak beberapa dekad yang lalu, banyak negara-nagara penerima bantuan tersebut seperti negara-negara Indocina masih kekal mundur dan mengalami pertumbuhan yang rendah. Kajiian ini dijalankan untuk mengkaji hubungan antara bantuan luar nageri dengan pertumbuhan ekonomi di negara Indocina iaitu, Kamboja, Laos, Myanmar, Thailand dan Vietnam untuk tempoh 1993 ke 2009. Pembolehubah yang digunakan dalam kajian ini termasuklah pertumbuhan ekonomi, bantuan pembangunan rasmi (ODA), pebaluran asing (FDI) dan keterbukaan perdagangan. Kaedah kointegrasi ARDL telah diaplikasikan dalam kajian bersama kaedah kausalitas untuk jangka pendek untuk mengkaji hubungan kointegrasi di kalangan pembolehubah. Hasil penelitian kajian ini menyatakan bahawa bantuan luar negeri and pertumbuhan ekonomi mempunyai hubungan songsang jangka panjang untuk Kamboja, Thailand dan Vietnam, manakala hunbungan tersebut tidak wujud di Laos dan Myanmar. Walaubagaimanapun, kesan bantuan luar negara pada pertumbuhan ekonomi didapati kurang ketara. Kesimpulan kajian ini mencadangkan bahawa negara-negara penerima bantuan luar negeri untuk supaya mengurangkan gantungan ke atas factor-faktor luaran termasuklah bantuan luar negeri.

ACKNOWLEDGEMENT

There are a few people which have contributed in various ways in my research which deserved special mention. First of all, I would like to acknowledge the guidance, advices and encouragement of Dr. Venus Khim Sen Liew from the very early stage until the completion of the study.

I would also like to express my gratitude towards my classmates and friends for sharing knowledge and helpful information generously.

I convey special thanks to my family particularly, my father and mother for giving continuous moral support throughout the completion of the research.

Lastly, I would also like to thanks both the academic staffs and non-academic staffs of Faculty of Economics and Business, UNIMAS who inspired and enriched my growth as a researcher and providing handy facilities during my research.

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CHAPTER 1: INTRODUCTION

1.0 Introduction

Since 1950s, foreign aid has become one of the most important sources of foreign capital inflow to the third world in order to cope with their relatively weak macroeconomic performance and alleviating poverty level. The developing countries are relatively prone to economic instabilities and are scarce in capital sources to overcome countless obstacles in achieving rapid development such as poverty and low productivity. Therefore, many of the richer countries want to reduce these difficulties faced by the developing countries through foreign aid as the world has become more integrated. Many international financial facilities such as World Bank, United Nation, International Monetary Fund (IMF), Organization of the Petroleum Exporting Countries (OPEC) and Organization for Economic Co-operation and Development (OECD) are supportive towards this project by raising funds directing towards the developing countries.

Indochina as one of the main recipient countries in the Southeast Asia region has undergone various difficulties in achieving sustainable economic growth although receiving considerably amount from the donors since 1980s. Therefore, the aid effectiveness in terms of generating growth is still questionable in the Indochina region. Furthermore, numerous studies have given little resolution and ambiguous results on the relationship between foreign aid and economic growth. Hence, aid-growth relationship is still open for further debate.

The purpose of the study is to analyze the effect of foreign aid inflows on economic growth using the Indochina countries as the sample. In order to study the relationship between foreign aid and growth, the literatures about aid-growth relationship are reviewed to obtain some idea to determine the approach to use in the study. From the reviewed literatures, the econometric methodology is developed to explore the aid-growth relationship empirically.

1.1 Foreign Aid

Foreign aid, also known as international aid is a voluntary transfer of resources internationally from one party to another. The main objective of aid is to improve the standard living of poor countries and ensure long term and sustainable welfare which requires continuous economic growth. Basically, foreign aid is provided in different forms depends on its function. Usually, it is claimed that aid is given in the name of humanitarian or ethical practices. Nevertheless, some aid provided is also based on political purposes and economic self-interest. Foreign aid comes in different forms, for instance, food aid, financial aid, technical assistance, military assistance, and funds for diseases relief (Whitaker, 2006). Foreign aid also comes in development aid and non-development aid. The development aid is the aid expended with a purpose to stimulate development, whether through economic growth or other means. Whereas non-development aid is defined as the aid of all other kind (Minoiu & Reddy, 2010).

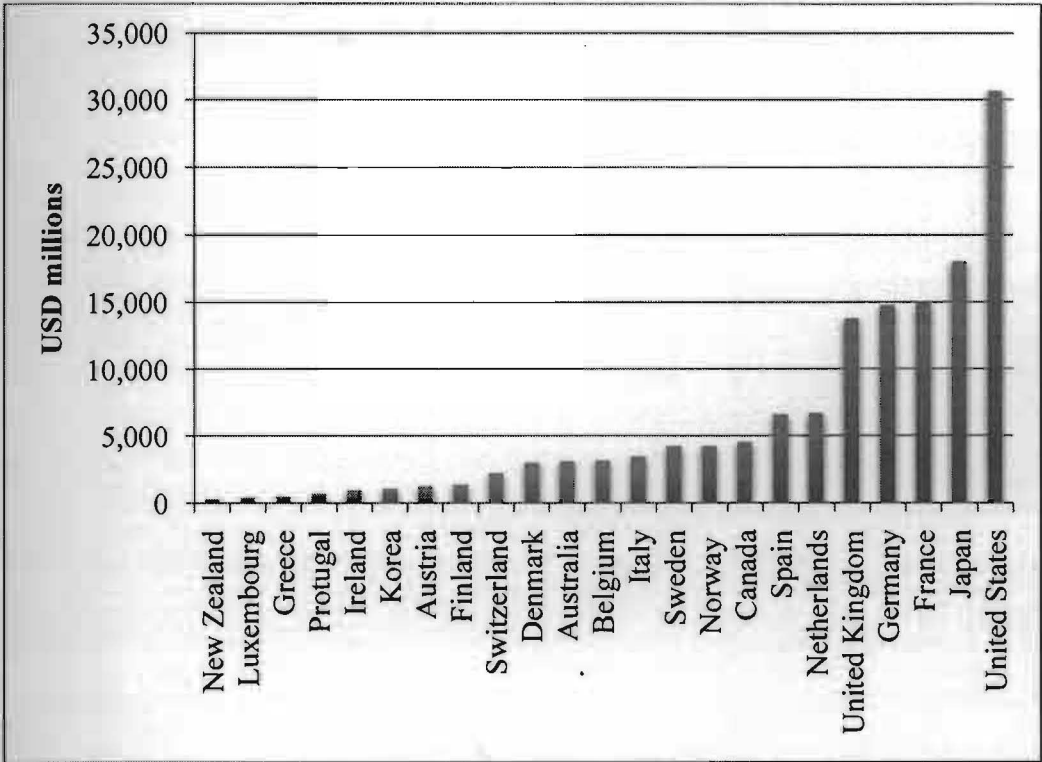
The Official Development Assistance (ODA) is the most widely used measure of foreign aid and it is compiled by the Development Assistance Committee

(DAC) of the Organization for Economic Cooperation and Development. The DAC consists of 22 richest developed countries. According to the OECD, ODA consists of disbursement of loans made on concessional terms and grants by official agencies of the members of the DAC, by multilateral institutions, and by non-DAC countries to promote economic development and welfare in countries and regions in the DAC list of ODA recipients. Basically, the function of ODAs are not only limited to poverty reduction, but the contributions are as well used for building education institutions, training schools, healthcare services and to improve infrastructure system providing the recipient countries a more constructive environment for growth and development. The amount of foreign aid flow to developing countries has increase over time where the ODA offered by DAC countries rises from \$48,539.24 million US dollars in 1970 to \$131,566.95 million US dollars in 2009 (OECD, 2011b). The developing countries are the major recipient of the ODA flow where it accounts for more than half of the total amount of ODA. The ODA flow from DAC countries to developing countries also has increased almost three folds from \$32,546.68 million US dollars in 1970 to \$83,502.85 million US dollars in 2009 (OECD, 2011b).

ODA can be distributed to the developing countries in two ways, through the bilateral aid or the multilateral aid. Bilateral aid involves a direct transfer from one country to another. Whereas, multilateral aid is indirectly transferred to the developing countries through international organizations and institutions such as the International Development Association (IDA), Asian Development Bank (ADB), European Union (EU) Institution and World Bank. These two types of aid are different in the sense that the type of aid can determine the type of development project to be funded. The bilateral aid is mainly associated with political

consideration and in some cases it is granted specifically for development projects. The abuse of the use of bilateral aid is called tied aid which is the allocation of aid with conditions stated by the donor countries for instance, to purchase the goods and services from the donor country. This might lead to disadvantage to the recipient countries such as distorting the term of trade. On the other hand, the multilateral aid from multilateral institutions is tend to be less tied and is mostly provided during difficult time such as weak economic performances, natural disasters and war.

Figure 1.1: ODA Flow by DAC Countries in 2009 (Constant USD millions)

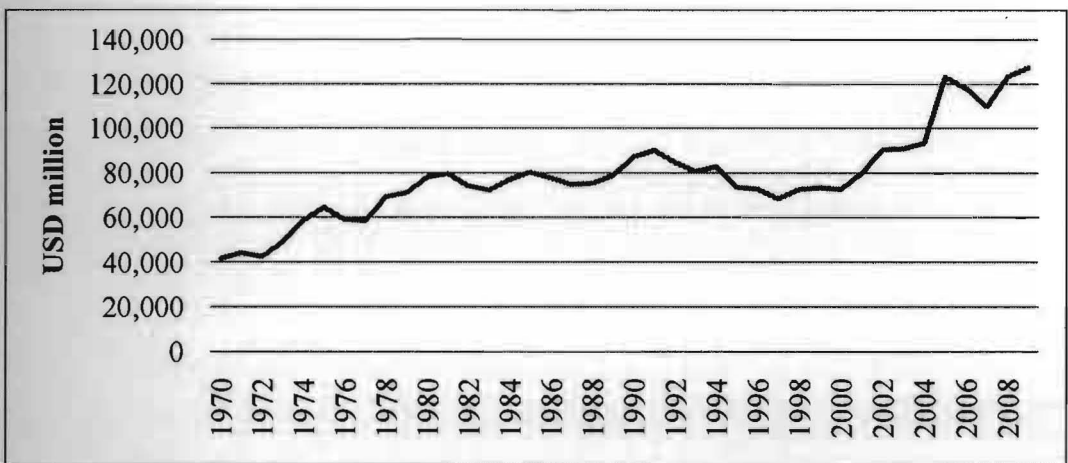


Source: Development Aid: Total Official and Private Flows, OECDStat, 2011

Figure 1.1 illustrates the ODA flows by DAC member countries in 2009. The United States remains as the largest ODA donor where it alone has contributed 22%

or \$30,650.02 million US dollars of the total in 2009. The high-income countries such as Japan, France, Germany and United Kingdom are also some important ODA donors that contribute around 10% of the total ODA and have continued to exceed to United Nation ODA target of 0.7% of Gross National Income (GNI).

Figure 1.2: ODA to Developing Countries by Total Donors (Constant USD million)



Source: ODA by Recipient, OECDStat, 2011

The developing countries are the major recipient of the ODA flow. Figure 1.2 shows that the amount of ODA received by developing countries. The ODA flow from total donors to developing countries has increased three folds from \$41,468.35 million US dollars in 1970 to \$127,427 million US dollars in 2009 (OECD, 2011b).

Foreign aid is scarce sources, which needs to be allocated efficiently as part of global efforts to reduce poverty. In this sense, the allocation of foreign aid is crucial in determining the aid effectiveness which is reflected by economic growth and other economical indicators. Although years of observations has gradually

forming consensus view that aid works on certain countries such as South Korea which has successfully taken off from being a permanent foreign aid recipient country to one of the most successful economy in the world. However other studies with panel-based empirical studies have found that the effect is not the same everywhere. It is revealed that there are still some parts of the world that received foreign aid such as the Indochina countries remain underdeveloped with serious poverty problems.

Many have doubts over the effectiveness of foreign aid in achieving its objectives, whether the contribution made by the donor countries are well-distributed in a manner that will eventually benefits the recipient countries. Moreover, the surge of studies regarding aid-growth relationship in early 1970s' where the discovery about the negative impact of foreign aid on growth has alarmed the policy-makers (Doucouliagos & Paldam, 2008). Majority of the aid-recipient economies such as the Indochina countries, African countries, and North American countries does not show significant improvement as expected although they have received development aid for almost half a century.

1.2 Background of the Study: The Indochina Countries

The Indochina region is located in the South East Asia and it lies roughly South West of China and East of India. The Indochina countries are bounded together as a peninsular and therefore sharing similar historical background and culture. The Indochina peninsular consists of former French territories such as Cambodia, Lao PDR and Vietnam. In a wider sense, the Myanmar and Thailand are

also considered as part of the Indochina countries due to the geographical aspect. In this study, all five countries which are Cambodia, Lao PDR, Myanmar, Thailand and Vietnam will be considered as the Indochina countries.

1.2.1 Cambodia

Official Name of Country	: Kingdom of Cambodia
Surface Area	: 181.04 km ²
Population (2010)	: 14.1 million
Urban Population (2010)	: 22.8% of total population
Rural Population (2010)	: 77.2% of total population
GDP (current US\$) (2010)	: \$11.3 billion US dollars
GDP Growth Rate (2010)	: 6.7%
GNI Per Capita (2010)	: \$760 US dollars
Inflation Rate (2010)	: 4%
External Debt (% of GDP)	: 39%
Unemployment Rate (2007)	: 3.5%
Labor Force (2009)	: 50.8% of total population
FDI Inflow (% of GDP)(2010)	: 6.9%
Balance of Payment (% of GDP) (2009)	: -8.3%

Source: World Development Indicators 2011, World Bank, 2011

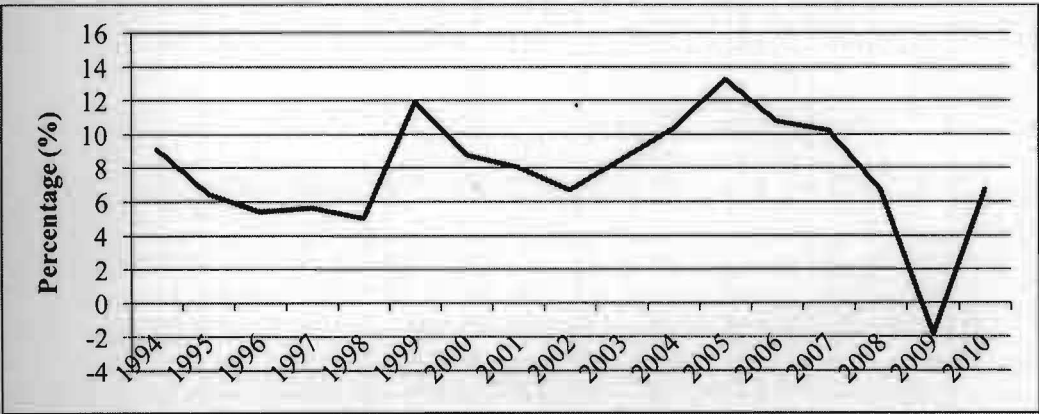
Since the gain of independent in 1953 from France, Cambodia has undergone many hardships in achieving full peace economically. After recovering from years of war and international isolation, Cambodia has become one of the emerging economies in South East Asia due to its high growth of average 10% each year coupled with new market opportunities and high potential for local economic development and attracting investment. Cambodia is categorized as a low income country with GNI per capita of \$690 US dollars in 2009 (WDI, 2011). In the past

few years, the continuous effort to develop the banking and financial sector alongside with the implementation of a cautious monetary policy has significantly contributed to the sustainability and good shape of macroeconomic environment.

In recent years, Cambodia has becoming more active in their service sectors such as the banking sector is now the main economic activities with 45.2% of the GDP followed by the agriculture sector (33.4%) and industrial sector (21.4%) (CIA The World Factbook, 2011). There are 57.6% of the labor force has participated in the agriculture sector.

Poverty is still a major issue in Cambodia where 56.5% out of the population are living with less than \$2 US dollars per day in 2007 (WDI, 2011). Although the poverty has shown improvement as the country grows, however, inequality is still prevailing because the growth mostly concentrated only in the urban area. Rural development is relatively slow as a result of persistent natural disaster such as flood and poor infrastructure and improper defined property rights.

Figure 1.3: Cambodia’s Annual GDP Growth (%), 1994-2010



Source: World Development Indicator, 2011

The economics of Cambodia has gradually picked up since 1989, after the Soviet Union was mantled. Cambodia gained its independence from France in 1953, achieving average of 10% GDP growth per year from 1998 to 2008 (figure 1.3) largely driven by rapid growth in the garment industry, construction, agriculture and tourism. However, the strong growth has been significantly interrupted by the financial crisis in 2008-2009 where the growth rate has drop around 2%. But it has experiencing quick recovering right after the crisis where the growth rate has rebounded to around 6.7% in 2009.

In 1989, the Cambodia economy has opened up for foreign investors. In 2003, the country has enforced the law on investment to encourage investment inflows and serve the foreign investor's interest. The government has provided substantial incentives to the investors to invest in the various sectors including infrastructure industry and human resources development. However, FDI activities remain moderate in Cambodia due to the lack of facilities in providing a sound environment to attracting foreign investors but the country has high potential to become a hub for FDI flows.

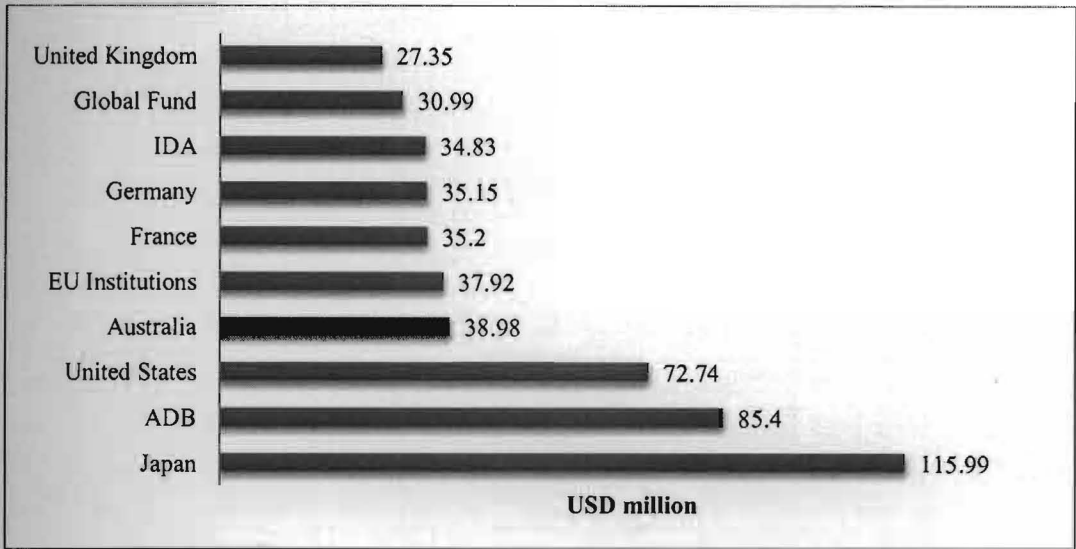
With political pressure, Cambodia has integrated its economy with the regional and international markets. It became a full member of Association of Southeast Asia Nations (ASEAN) in 1999 and the World Trade Organization (WTO) in 2007. Since engagement into the trade agreements, the trade activity has multiplied, leading to rapid economic development and poverty reduction. Although the trade activities have been robust in Cambodia, the import volumes are outpacing the exports in recent years by around \$2 billion US dollars. Nevertheless Trade activities are very important in the Cambodia economy where the trade to GDP ratio

is 122.26% (WDI, 2011). The main export is agriculture products and textile manufactured products and its export largest partner is the United States; while import commodities of Cambodia include automobiles, machinery and petroleum products mainly imported from Asian countries such as Thailand, Singapore and China.

In addition to the rapid increase in trade volume and FDI inflow, the ODA has substantially added momentum to economic development and poverty reduction in the country. Cambodia is one of the ODA recipient countries for the due to its high potential of reforms and acute need for postwar development. Cambodia is highly aid-dependent, with most of the development activities are financed by the received ODA. Aid received are 8% out of its GNI and it accounts for roughly half of the national budget (WDI, 2011). In 2010, Cambodia has received approximately \$722.3 million US dollars of ODA. The expenditure of the government are highly rely on the ODA provided for around 63% of the central government expenditure came from ODA received in 2009 (WDI, 2011).

The supply of bilateral and multilateral ODA for Cambodia is mostly contributed by the DAC countries and Asian Development Bank (ADB), European Union (EU) Institutions, International Development Association (IDA) and Global Fund. The main ODA donors are computed in figure 1.4. Japan and United States remains as the largest bilateral ODA provider in Cambodia, contributing average around \$116 million US dollars and \$73 million US dollars respectively per year. The multilateral institutions such as ADB and EU institution are also contributed substantially to the ODA disbursements of Cambodia.

Figure 1.4: Main Sources of Net ODA Disbursements for Cambodia (Average 2005-2009 in US\$ Million)



Source: OECD/DAC Database, OECD, 2011

The funds provided are allocated in various sector such as the social sector and production sector to stimulate development. The allocation of ODA disbursements are illustrated in figure 1.4. Generally, the ODA disbursements in Cambodia are mainly used in the social sector, where over half of the disbursements are used to improve their health care services and other social services. 11% of the disbursements are used in developing facilities for economic activities which are exceptionally essential in promoting economic development.

Over the past decade, Cambodia and its development partners have dedicated to improve the quality of development assistance. The Cambodian government has established a single focal point for ODA management, and a separate institution for managing the development partnership. Nevertheless, the results of the 2008 Paris Declaration Monitoring Survey suggest that considerable effort is still required to make further improvement on aid-effectiveness.